INTRODUCTION

The system of classification of assets is one of the tools used to evaluate asset quality to determine the adequacy of valuation allowances. Classification of assets serves several purposes for both the Office of Thrift Supervision (OTS) and savings associations. Asset classifications can be used as a management tool to identify and monitor portfolio risk. An analysis of a savings association's classified assets is essential to the proper evaluation of a savings association's asset quality, financial condition, and ultimately, the risk to the Savings Association Insurance Fund (SAIF). The level of asset problems, as evidenced by classifications, also serves as a reflection of management's abilities to implement sound operating policies and procedures and to comply with regulatory requirements.

All savings association assets are subject to classification. Additionally, Substandard and Doubtful classifications must be considered in the determination of an adequate level of an association's general valuation allowances. Loss classifications require either the establishment of a specific allowance or charge-off of 100% of the balance so classified. (Refer to Thrift Activities Regulatory Handbook Section 261, Adequacy of Valuation Allowances.)

Asset Quality Ratings

As fully developed in Thrift Activities Handbook Section 209, Sampling, regulators select a sample of assets for review and analysis to determine credit quality. Each asset reviewed is assigned a quality rating based on a regulator's best judgment of the likelihood of repayment or orderly liquidation. Asset quality ratings are divided into three groups: Pass (unclassified), Special Mention, and Classified (adverse classification).

Pass

A Pass asset is considered of sufficient quality to preclude a Special Mention or an adverse rating. Pass assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral.

Special Mention

On June 10, 1993, the federal banking and thrift regulatory agencies issued uniform guidance to clarify the use of Special Mention for supervisory purposes. The four agencies adopted the following uniform definition for Special Mention assets:

> The Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Assets that could be included in this category include loans that have developed credit weaknesses since origination as well as those that were originated with such weaknesses. This includes loans the institution is unable to properly supervise because of an inadequate loan agreement, inadequate control over collateral (when such control is necessary to effect full repayment of the loan), or when a loan is made with significant deviations from prudent lending practices. An adverse trend in the obligor's operations or the obligor's highly leveraged balance sheet may warrant a Special Mention designation, provided that neither condition has deteriorated to the point that timely repayment is jeopardized. If timely payment is jeopardized, an adverse classification may be warranted.

Special Mention should not be used to identify an asset that has as its sole weakness credit data exceptions or collateral documentation exceptions that are not material to the timely repayment of the asset. For example, the failure of an institution to obtain current borrower financial statements on a performing loan does not, by itself, indicate a weakness in the loan and should not be cause for the loan to be automatically designated Special Mention. There may be cases, however, where borrowers fail to provide updated financial statements because they are reluctant to disclose their poor operating perform-

ance, which could justify Special Mention designation or adverse classification. For large dollar amount loans, where the decision as to whether to classify the loan is heavily dependent on the borrower's (or property's) cash flows, regulators should have the institution obtain current financial statements during the examination or initiate other verification measures.

The Special Mention designation may also be appropriate when the collateral agreement of a performing loan is not properly executed. In such a case, if the borrower is dependent on the sale of, or the cash flow from, the collateral to repay the loan in a timely manner, then a Special Mention designation is appropriate (or, if timely repayment is jeopardized, an adverse classification may be warranted).

On the other hand, regulators should not designate as Special Mention a performing construction loan where the institution has failed to inspect construction in progress. The lack of such inspections is a deficiency in the institution's loan administration function and does not (by itself) indicate a weakness in the loan that may result in deterioration of the repayment prospects of the loan.

Finally, the Special Mention designation should not include loans listed merely "for the record," such as when uncertainties and complexities, coupled with a large loan amount, create reservations about the quality of the loan. Regulators are not expected to identify all loans that will become troubled at some future date. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of an asset as Special Mention is not justified.

Careful identification of assets that properly belong in this category is important to determine the extent of risk in the portfolio and to provide constructive criticism to management. Generally, Special Mention assets will not be individually detailed in the report of examination (ROE). When Special Mention assets are detailed in the ROE, however, the loans should be written up in a manner similar to that used for adversely classified assets per the instructions outlined under the subheading, "Classified Asset Comments," found later in this Section.

Regulators should not combine Special Mention assets with classified assets in the ROE or other reports. As appropriate, however, regulators should continue to consider the level and trends of Special Mention assets in their analysis of the institution's overall asset quality.

Adverse Classifications

As provided for in the regulations, there are three adverse classification:

Substandard: An asset classified Substandard is inadequately protected by the current net worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified must have a well- defined weakness or weaknesses. They are characterized by the distinct possibility that the association will sustain some loss if the deficiencies are not corrected. [12 CFR § 563.160.]

Assets classified Substandard may be characterized by one or a combination of the following weaknesses:

- Primary source of repayment is gone or severely impaired and the association may have to rely upon the secondary source;
- Loss does not seem likely, but sufficient problems have arisen to cause the association to go to abnormal lengths to protect its position in order to maintain a high probability of repayment;
- Obligors are unable to generate enough cash flow to reduce their debts;
- Deterioration in collateral value or inadequate inspection or verification of value (if the collateral is expected to be the source of repayment);
- Flaws in documentation leave the association in a subordinated or unsecured position when the collateral is needed for the repayment of the loan.

The presence of one or more of these factors does not mandate that the asset be adversely classified if, in the regulator's judgment, the presence of such factors does not indicate a weakness that jeopardizes the timely liquidation of the asset or disposition of the collateral, at the asset's book value.

Doubtful: An asset classified Doubtful has the weaknesses of those classified Substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently

existing facts, conditions, and values, highly questionable and improbable. [12 CFR § 563.160.]

The likelihood of a loss on an asset or portion of an asset classified Doubtful is high. Due to important and reasonably specific pending factors, however, its classification as Loss is not appropriate. Factors that may result in a Doubtful rather than Loss classification include: real property collateral whose value is uncertain due to toxic waste cleanup; proposed merger, acquisition, or liquidation procedures; capital injection; perfection of a lien on additional collateral; or refinancing plans.

The Doubtful classification should not be used to defer the full recognition of an expected loss. Management should attempt to identify, then recognize, losses in a timely manner.

Loss: That portion of an asset classified Loss is considered uncollectible and of such little value that its continuance as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer writing off a basically worthless asset (or portion) even though partial recovery may be effected in the future. [12 CFR § 563.160.]

An asset may be subject to a "split classification," whereby two or more portions of the same asset are given separate classifications. For example, assume that an association has an unsecured loan to a company in liquidation. The bankruptcy trustee has indicated a minimum disbursement of 40% and a maximum disbursement of 65% to unsecured creditors. In this situation, estimates are based on liquidation value appraisals with asset values yet to be realized. A proper classification would show 40% Substandard, 25% Doubtful, and 35% Loss. Therefore, if an association uses specific valuation allowances in lieu of charge-offs, both specific and general allowances would be established on the same asset. (Refer to Thrift Activities Regulatory Handbook Section 261, Adequacy of Valuation Allowances.)

Self-Classification

Savings associations are required by § 563.160 to independently review, classify, and set aside appropriate valuation allowances for their assets. OTS's classification system encourages associations to identify weaknesses inherent in their lending strategies and practices in addition to quantifying current problems. It serves as an early warning system and is a crucial tool to reduce the risks of loss to both the association and the SAIF. It can reveal lending patterns or deficiencies in portfolio administration that consistently cause an association collection problems. Once the association identifies such patterns or deficiencies, management and the board of directors can avoid practices that have resulted in a higher level of classified assets. In this way, the classification process can serve as a preventive, as well as a protective, function.

Although associations are not required to use the same categories as presented above, the categories should correlate to the classification definitions. This will serve to facilitate the examination process and the preparation of quarterly reports to OTS of aggregate totals in each of the three asset classification categories.

The regulator's primary focus should be to highlight and correct weaknesses in the association's self-classification system. A well-organized, competent, and independent internal asset review department that encompasses the self-classification process will ultimately result in less regulator time spent on loan reviews and asset classifications. It would be expected that the asset review department will segregate problem and potential problem loans and other assets, and provide a comprehensive analysis of these and larger credits. In those associations with a qualified asset review department, a regulator's time may be spent in review and possible update of the work performed by that department. Internally prepared credit quality analyses should be reviewed to determine concurrence with the association's assigned ratings. Larger credits that have not been assigned an adverse classification should be sampled to determine concurrence with the Pass rating and the integrity of the system. (Refer to Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment, as well as Section 209, Sampling.)

Association management is expected to update classifications between examinations, based on improvements or deterioration that occurs. The proper monitoring of asset quality necessitates the association's ability to either upgrade or downgrade classifications. If it is

determined that an association abuses its privilege to upgrade classifications, the regional director has the authority to revoke such privilege. In this situation, the association would continue to report self-classifications; however, no regulator-accorded classifications could be upgraded between examinations unless the asset classified had been liquidated or the institution receives the prior approval of the OTS to upgrade a classification. It is expected that a regulator's classifications should closely parallel those of the association. Where they do not, a careful review of the association's self-classification procedures is warranted to determine the reasons for the disparity.

Classification Considerations

Presented below are considerations that should be kept in mind when specific asset portfolios are reviewed. (Refer to individual asset quality Sections of this Handbook for more detailed analysis considerations.)

Commercial Loans

In the analysis of commercial loans for classification purposes, consideration is given to the purpose of the loan and the risk inherent in the project; the nature and degree of collateral security; the character, capacity, financial responsibility, and performance record of the borrower; and the feasibility and probability of orderly repayment of the loan in accordance with specified terms. The willingness and ability of a debtor to perform as agreed is the primary measure of the risk of the loan. This implies that the borrower must have earnings or liquid assets sufficient to meet interest payments and provide for reduction or liquidation of principal as agreed at a reasonable and foreseeable date. It does not mean, however, that borrowers must at all times be in a position to liquidate their loans, for in many cases that would defeat the original purpose of extending credit.

Commercial real estate loans are often primarily dependent on the cash flows of the underlying security to meet scheduled debt service. Regulators should analyze historical and projected cash flows and underlying assumptions of the property to determine if there is a sufficient debt service coverage (the net cash flows of the property divided by the required debt service).

Secondary sources of repayment, such as guarantors or endorsers, must be evaluated for ability and willingness to provide debt service when the primary repayment source is unable to perform. Regulators should consider the association's track record. Has it been able to successfully collect on such guarantees or endorsements in the past? Secondary sources of repayment may mitigate the loss potential on commercial loans. Regulators should review the guarantor's current financial information and past payment history, and judge whether orderly repayment of the debt through a secondary source will continue.

When a troubled commercial real estate loan is analyzed for a possible Loss classification, the regulator must consider the likelihood of the association obtaining title to the property through either foreclosure or a deed in lieu of foreclosure. Loans that an association has restructured are neither automatically classified nor exempt from classification. The credit must be analyzed in the same manner as other loans to determine risk of nonpayment. (Refer to Thrift Activities Regulatory Handbook Section 240, Troubled Debt Restructurings.)

Commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral are generally not classified. Similarly, loans to sound borrowers that are renewed or refinanced in accordance with prudent underwriting standards to creditworthy commercial borrowers should not be classified unless well-defined weaknesses exist that jeopardize repayment. An institution should not be criticized for continuing to carry loans having weaknesses that result in classification as long as the institution has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage these loans.

In evaluating commercial real estate credits for possible classification, regulators should apply the standard classification definitions described in 12 CFR 563.160. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and the cash flow provided by, all collateral that supports the loan, and any support provided by financially responsible guarantors.

The loan record of performance to date is important and must be taken into consideration. As a general principal, a performing commercial real estate loan should not automatically be classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. It would be appropriate, however, to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the

lack of credible support for full repayment from reliable sources.

These principles hold for individual loans, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each loan should be based on the fundamental characteristics that affect the collectibility of the particular loan. The problems broadly associated with certain segments of an industry should not lead to overly pessimistic assessments of individual loans that are not affected by the problems of the troubled sectors.

Valuation and Classification of Troubled, Collateral Dependent Loans[1]

Effective March 31, 1995, OTS's policy for troubled, collateral-dependent loans (where proceeds for repayment can be expected to come only from the operation and sale of the collateral) is as follows:

For a troubled, collateral-dependent loan where, based on current information and events, it is probable that the lender will be unable to collect all amounts due (both principal and interest), the amount classified Loss should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard**.**

For a troubled, collateral-dependent loan, it is probable that the lender will be unable to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are less than the principal and interest payments due according to the contractual terms of the loan agreement. The term "all amounts due" is based on the original contractual terms, except as discussed below.

For a troubled, collateral-dependent loan (whether or not restructured) where, based on current information it is probable, but not reasonably assured, that the lender will be able to collect all amounts due (both principal and interest), the amount classified Doubtful should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard.

For a troubled, collateral-dependent loan, it will be deemed probable, but not reasonably assured, that the lender will be able to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are equal to or greater than the principal and interest payments due according to the contractual terms of the loan agreement.

An exception to this policy is for a loan that was restructured in a troubled debt restructuring involving a modification of terms prior to September 30, 1993. For loans restructured before September 30, 1993, the evaluation for probability of collection may be based on the collectibility of principal and interest under the restructured contractual terms. For all restructured loans, including loans modified before and after September 30, 1993, that become impaired after modification, the loan should be measured at the fair value of the collateral as discussed above.

OTS does not allow savings associations to use general valuation allowances to cover any amount considered to be a Loss under the above policy; however, Specific Valuation Allowances (SVAS) may be used in lieu of charge-offs.

Mortgage Loans (One- to Four-Family, Owner-Occupied Dwellings)

The primary indicator for classifying owner-occupied home loans is the past payment history. As such, slow loans (§ 561.48) provide a good starting point to determine the mortgage loans to be adversely classified. Due to the volume of such loans in the thrift industry, a regulator's time should not be invested in individual review of all slow mortgage loans to determine if adverse classification is

[1] The policy described in this Section does not apply to smaller balance homogeneous loans (such as one- to four-family owner-occupied home mortgage loans) that are generally classified on the basis of delinquency status.

appropriate. Rather, all slow mortgage loans are presumed to be Substandard, with the burden placed on management to provide reasons for nonadverse classification of individual credits. Possible reasons for not adversely classifying a slow mortgage loan might be the imminent sale of the property (evidenced by a signed agreement) that will liquidate the loan, or payments received during the examination that eliminate the loan from a slow status.[2]

Loans or contracts to facilitate the sale of foreclosed mortgages, though generally of higher risk due to high loan-to-value ratios, are not, by definition, slow loans. These loans are not presumed Substandard. The loan should be evaluated on the borrower's perceived ability to service the debt. Loans should not be adversely classified merely due to high loan-to-value ratios. In those associations with a material volume of loans to facilitate, the regulator should sample such loans to assure that sound underwriting criteria are followed; if sound underwriting criteria are not followed, all such loans may be reviewed. If a review of these loans provides the regulator with a sufficient degree of confidence that loans to facilitate are granted to borrowers with an ability to service the debt, then adverse classification may be limited to those loans that are slow. Again, management has the opportunity to provide documentation to support a Pass classification.

Consumer Loans

Consumer loans are credits extended to individuals for personal, family, or household expenditures, as defined in 12 CFR § 561.12. Evidence of the soundness of a consumer loan is best indicated by the repayment performance demonstrated by the borrower. This consideration, coupled with the fact that consumer loans are typically small in size and large in number, mandate a different approach to classification. Regulators are to follow 12 CFR §§ 561.13 and 561.47 when open-end and closed-end consumer credit are classified.

These regulations provide that: closed-end consumer installment credit delinquent 120 days or more (five monthly payments) will be classified Loss, and loans delinquent 90 to 119 days (four monthly payments) will be categorized as Slow. Open-end consumer installment credit (credit cards) delinquent 180 days or more (seven zero billing cycles) will be classified Loss, and loans delinquent 90 to 179 days (four to six zero billing cycles) will be categorized as Slow. As with owner-occupied mortgage loans, Slow credits are presumed Substandard, subject to management providing documentation that such an adverse classification is not warranted.

If an association can clearly demonstrate that repayment will occur regardless of delinquency status, then such loan need not be classified as Substandard or Loss. Examples of such situations are: the loan is well-secured by collateral and is in the process of collection; the loan is supported by a valid guarantee or insurance; or it is a loan where claims have been led against a solvent estate. "Well-secured" implies collateralization by liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt in full, or collateralization by the guarantee of a financially responsible party. "In the process of collection" infers collection is proceeding in due course either through legal action or, in appropriate circumstances, through collection efforts not involving legal action that are reasonably expected to result in repayment of the debt or its restoration to a current status. For the purpose of computing delinquency, a payment of 90% or more of the contractual payment will be considered a full payment.

OTS regulations at 12 CFR §§ 561.13 and 561.47 do not preclude the adverse classification of consumer credit delinquent for a lesser period, or not delinquent, when such classification is warranted.

[2] When computing whether a modified or re danced loan is Slow, "(t)he date on which the association obligates itself is the date on which the modification or re financing becomes effective. Such a transaction becomes effective when all conditions precedent have been met by the borrower, thereby binding the association. For example, in states having an escrow procedure, a modification or re financing would become effective when all conditions of the escrow had been met." (Based on an internal interpretation of the General Counsel issued January 4, 1966; formerly issued as FHLBB Memorandum T 16-1.)

Investment Securities

Classification of investment securities is based on credit risk, not interest-rate risk. A decline in the market value of a security simply due to interest-rate fluctuations is not a basis for adverse classification. Classification should be based on the credit risk and collectibility of interest and principal that the association has booked as an asset.

In assessing the credit quality of securities, associations and regulators will find the qualitative ratings provided by recognized investment advisory services to be helpful guides. Regulators should become familiar with the various rating services and the qualitative standards implicit in their respective rating systems. See Thrift Activities Regulatory Handbook Section 220, Investment Securities, for rating descriptions.

Securities that are currently rated in the first four rating categories by these investment advisory services are generally considered of investment quality and not adversely classified. Securities that are not rated but are considered of comparable quality to securities in the first four rating bands are also generally not adversely classified. Associations should maintain current credit information on securities to assist in the determination of credit quality.

Ratings accorded by investment advisory services should not be regarded as absolute evidence of overall credit quality; therefore, associations and regulators should not feel constrained from deviating from the published ratings. However, in those instances where the recognized rating services are unanimous in assigning a rating and the regulator assigned a conflicting, adverse classification, the facts, as presented in a detailed write-up, must clearly and demonstrably support the examiner's findings. The ultimate and conclusive test of investment quality is actual credit soundness. The principles underlying analysis of credit soundness are essentially the same as those applicable to loan analysis.

Regulators should contact their regional offices for guidance before they adversely classify any security.

Noninvestment-Grade Corporate Debt Securities: FIRREA mandates that savings associations divest of all noninvestment-grade corporate debt securities as soon as prudently possible and in all cases by July 1, 1994. OTS applies the "Uniform Agreement on the Classification of Assets" of the federal bank regulatory agencies to all noninvestment-grade corporate debt securities.

The "Uniform Agreement" states that, "Securities in grades below the four highest ratings grades and unrated securities of similar value (quality) will be valued at market price and the depreciation will be classified Doubtful; remaining book value will be classified Substandard. Depreciation in defaulted securities will generally be classified Loss; remaining book value will be classified Substandard." For noninvestment-grade corporate debt securities, any excess of amortized cost over fair value is classified Loss (specific allowance or charge-off) and the remaining book value is classified Substandard.

Real Estate Acquired by Foreclosure

At foreclosure, foreclosed assets, including real estate acquired by foreclosure, are to be reported at the lower of: (1) the recorded investment in the loan (i.e., cost) or (2) the fair value of the foreclosed asset. Any excess of recorded investment over fair value is to be classified Loss and is to be charged-off. This Loss classification may not be represented by a valuation allowance. Accordingly, the lower of: (1) the recorded investment in the loan or (2) the fair value of the foreclosed asset becomes the new recorded investment in the foreclosed asset. Legal fees and direct costs of acquiring title to foreclosed assets are to be expensed as incurred.

The recorded investment in the loan includes the balance of principal, accrued interest, deferred origination fees and costs, and purchase premium or discount. The recorded investment in the asset does not reflect any valuation allowances; the carrying value of the asset does reflect valuation allowances. Fair value is to include a reduction for the seller's disposition costs, and is to be substantiated by a current appraisal at the time of acquisition (see 563.172).

Subsequent valuations of foreclosed assets should follow the guidance provided in Handbook Section

251, "Real Estate Owned and Repossessed Assets."

Real estate acquired by foreclosure is often an unsound asset, even when recorded at fair value. The association's acquisition of the property is normally indicative of a lack of demand. As time lapses, the lack of demand becomes more apparent, and the soundness of real estate for which there is no demand (at least at the current "asking price") becomes more questionable. This is not to say that an adverse classification is mandatory. Each parcel of REO is to be reviewed and classified on its merits. In making that judgment, it is necessary to: identify the reason for the foreclosure of the property; determine the association's intentions as to disposition of the property; compare the property's carrying value to its current market value; find out the "asking price" and any offers the association has received; determine the length of time the property has been held and reasons it has not been sold; and review other pertinent factors, such as insurance coverage, additional liens, present occupancy, income, and expenses, etc. A careful evaluation of the relevant factors, many of which are mentioned above, should enable the regulator to make an accurate and reliable judgment with regard to classification. (Refer to Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Debt and Equity Investments in a Subsidiary

An association's investment in a service corporation may take many forms, some of which are listed below:

- Debt investment through collateralized loans
- Unsecured loans
- Capital stock
- Capital infusions
- Guarantees of debt
- Retained earnings
- Letters of credit
- Assumption of debt
- Advances not typically documented as loans.

Associations are required to periodically evaluate their investments in service corporations and subsidiaries, and to make any appropriate adjustments to the carrying value based on that evaluation. An examiner should first determine that the association does this evaluation and adjustment. Also, the examiner should ascertain that the service corporation's assets reflect generally accepted accounting principles' (GAAP) valuation standards. Losses and allowances should be booked on the subsidiary's accounts for any asset deserving such treatment. The effect on the service corporation's financial statements of such losses and allowances may also be reflected in the association's investment in the subsidiary.

According to generally accepted accounting principles (GAAP), all consolidated losses (i.e., ownership exceeds 50% and control is exercised) of service corporations flow through to the parent association. Losses of service corporations that are accounted for by the equity method (i.e., ownership of 20% to 50% without control) decrease the book value of equity investments in service corporations and are run through the parent association's income statement. The equity investment is then adjusted for pro t/losses and can even be reduced below zero under certain circumstances. For example, if losses exceeding the amount of the investment are recorded and guarantees exist, or management continues to fund losses, the investment may be reduced below zero. Adjustments to the book value of an investment in service corporations accounted for by the cost method (i.e., less than 20% ownership without control) are made only when permanent impairments in value occur.

To illustrate, assume an association has a $1 million equity investment in ABC, a wholly owned subsidiary, that includes the retained earnings of ABC and represents all of ABC's net worth. The thrift has also guaranteed a $1 million loan from a third party to ABC, and has made $20 million in unsecured loans to ABC. ABC has a $10 million loan to a real estate developer that is secured by property recently appraised at $6 million.

Provided there are no other sources of repayment of the $10 million loan, ABC will probably have to recognize a $4 million loss on its loan to the devel-

oper. That would eliminate ABC's equity and result in a negative net worth of $3 million on ABC's books.

Reporting on an unconsolidated basis, the parent would write down its $1 million equity investment in ABC to zero. The parent would also write down its $20 million in unsecured loans to ABC to $17 million to recognize the diminution in value of those unsecured loans to ABC. Although ABC would have a net worth deficit of $3 million on its books, the parent would report its equity investment in ABC as zero on the quarterly Thrift Financial Report.

On the parent's GAAP financial statements, the $4 million loss on ABC's loan to the developer would be consolidated with the operating results of the parent, and the balance sheets of ABC and the parent would be consolidated. Intercompany transactions, such as the $20 million in unsecured loans to ABC, would be eliminated.

In terms of classification of assets, if the service corporation is not an "includable subsidiary" under 12 CFR 567, an examiner should first ensure that the association has evaluated its investments in and loans to the subsidiary and that any appropriate adjustments to the carrying value of such assets have been made. After ensuring this evaluation and appropriate adjustments have been made, an examiner should, in general, not classify either the assets of the service corporation or the savings association's loans to and investments in the service corporation. Due to the capital rule's "deduction from capital" of all such loans and investments, the association is insulated from the risk of the "nonincludable" service corporation.

An exception to this general policy on classification applicable to "nonincludable" subsidiaries is allowed for instances where the capital rule has not yet fully deducted all loans and investments (e.g., during the transition period). During the transition period, an examiner may classify the loans to and investments in these subsidiaries if the risk of loss associated with the loans and investments is not sufficiently covered by the GAAP-required adjustments and the amount subject to the deduction requirement. A second exception is for instances where a savings association has extended guarantees on behalf of a "nonincludable" subsidiary. If such guarantees subject the association to a sufficient degree of risk to warrant adverse classification, examiners should appropriately classify the guarantees.

For a service corporation that is both an "includable subsidiary" under 12 CFR 567 and an "operating subsidiary" under 12 CFR 545.81, an examiner should review and, where appropriate, classify the assets of the subsidiary. An operating subsidiary is generally treated as a department of the association and, for classification purposes, should be fully consolidated with the association (e.g., the assets of the operating subsidiary are combined with the assets of the association and all intercompany transactions are eliminated).

For a service corporation that is an "includable subsidiary" under 12 CFR 567 but that is not an "operating subsidiary," the examiner should review and, as appropriate, classify the association's loans to and investments in the subsidiary. Again, the examiner should first ensure that the association has evaluated its investments in and loans to the subsidiary and that any appropriate adjustments to the carrying value of such assets have been made. After ensuring this evaluation and appropriate adjustments have been made, the examiner should evaluate the assets of the subsidiary to determine the worth of an equity investment by the parent thrift and the ability of the subsidiary to repay debts owed to the parent. Like any other asset at the thrift level, for purposes of classifying an association's loans to or investments in these subsidiaries, the examiner should analyze the financial strength of the borrower and the quality and sufficiency of collateral to determine the orderly repayment of debt.

In those instances where the subsidiary is not being operated within an adequate degree of separation such that the parent is insulated from the operations of the subsidiary, the parent may be deemed liable for the obligations of the subsidiary as described in § 571.21, which describes attributes of corporate separateness. Section 563.37(a) requires that each association and service corporation thereof be operated in a manner that demonstrates to the public their separate corporate existence. Regulators should ensure that an association and its service corporation comply with § 563.37, applying the § 571.21 attributes.

Off-Balance-Sheet Items

All dollar amounts listed under an adverse classification heading for an off-balance-sheet item may be footnoted in the ROE to indicate that the adverse classification is contingent upon funding. However, the gross amount of the item is the basis for determining the balance of the classified asset. Specific allowances or charge-offs must be established for such items classified Loss. Off-balance-sheet items classified Substandard or Doubtful should be considered when assessing the adequacy of general valuation allowances.

Loan Commitments: A loan commitment may be classified if it is ascertained that the commitment is legally binding or management has provided assurance that funding will occur. The commitment should be evaluated as if it were a loan presently on the books of the association, and the portion classified should be based on the amount to be disbursed. Current financial statements of the prospective borrower, along with collateral, should be reviewed to determine risk of nonpayment.

Letters of Credit: Letters of credit (LOCs) should be reviewed and classified, as appropriate, based on the same criteria used for the classification of commercial loans. Letters of credit should be classified if disbursement is likely and a credit weakness exists with the account party. In such cases, regulators should determine the appropriate classification, and require valuation allowances for the particular circumstances. (Letters of credit are discussed in Section 215 of the Thrift Activities Regulatory Handbook.)

For example, an association issues a $1 million standby LOC as credit support to guarantee payment on a $10 million securitized pool of automobile loans on behalf of the investors (LOC beneficiaries). If the delinquency within the pool became so large that the seller/issuer of the pool was unable to meet the terms of the securities contract (partial default), the beneficiaries would be able to collect the $1 million from the LOC issuer, which in turn would attempt to collect from the seller. If the collateral was insufficient to satisfy the obligation, and repay the LOC issuer, a loss would result. Regulators should review the LOC agreement, and the performance of the collateral pool, to determine the appropriate classification. An example of a problem LOC follows:

Year 1: No significant problems, but LOC issuer has poorly documented the credit and financial capacity of the bond issuer and has inadequate documentation of the pool's performance. Delinquency begins to rise. The likelihood of payment under the LOC agreement cannot be determined. The LOC may be designated Special Mention if the regulator believes that the rising delinquencies and other problems may adversely affect the institution's credit position.

Year 2: Delinquencies become so large that the bond issuer must make payments from its own limited cash reserves. The LOC is classified Substandard, due to the likelihood of drawdown plus limited repayment sources.

Year 3: Bond issuer defaults, and the investors demand payment under the terms of the LOC agreement. During the course of the year, the full $1 million is paid to the investors. The payment by the association results in an extension of credit (loan) to the bond issuer. Since the collateral will primarily be used to repay investors, it is believed that the association will incur a significant loss. The loan is classified at least Doubtful.[3]

End of Year 3: Issuer files bankruptcy and bondholders stand to lose some of their investment. The LOC issuer charges off the $1 million advanced under the LOC.

Loans in Process, Including Lines of Credit: Similar to loan commitments, it should be ascertained that additional funding will occur. If losses are probable and estimable in loans where full funding has yet to occur, the appropriate amount classi able is the gross amount of a loan, rather than only the funds disbursed. For example, assume an association has funded $400,000 of a $1,000,000 construction loan. Despite a $700,000 current value, it has been ascertained that full funding will occur. If the loan is troubled and collateral-dependent, and the expected cash flow from the collateral is insufficient to meet required prin-

[3] The association or regulator might just as appropriately charge off the loan at this point, depending on the perceived likelihood of repayment.

cipal and interest payments, generally the appropriate classification for this loan is $700,000 Substandard and $300,000 Loss.

Litigation: Probable and estimable losses from litigation are generally accounted for by the establishment of a liability, as opposed to a contra asset account (specific or general allowance). If, however, an adverse ruling is expected from a litigious matter and such adverse ruling will result in the noncollection of an asset presently outstanding, an adverse classification of the asset is warranted, and a specific allowance or charge-off should be established.

Fixed Assets

Fixed assets used for business operations are depreciated and are generally not subject to adverse classification. Situations may arise, however, where such a classification is warranted. For instance, if property had been acquired for future expansion and it has since been determined that the expansion will not occur, the property should be reclassified as real estate held for development, investment, or resale. If held for resale, the property should be carried at the lower of cost or fair value. If the property is classified real estate held for development or investment, it should be carried at the lower of cost or net realizable value (NRV). For example, an association holds a trailer that had formerly been used as a branch office and has ceased business operations at the facility. The asset should be classified as a property held for resale and carried at the lower of cost or fair value.

Other Assets

Deposits in Other Associations: Pursuant to Resolution No. 88-184 and the Federal Home Loan Bank (FHLB) As-Agent Program implemented by a district bank, investments in deposits of associations shall be exempt from the asset classification system set forth at § 563.160. The resolution further indicated that all district banks are authorized to proceed with As-Agent Programs to place deposits in associations designated by a regional director as being under supervisory control. Associations investing in such deposits need not be located in the same region as the association in which the deposits are placed.

Repossessions: A repossession should be booked at the lower of the recorded investment in the loan satisfied or the property's fair value on the date the association takes clear title and possession of the property. Any excess of the recorded investment in the loan over fair value must be first charged against a specific allowance, if any. Any remaining loss amount should be charged against the general allowance. Generally, repossessions should be disposed of in a reasonably short period of time. As noted with REO, the longer an asset remains in the repossession account, the more suspect is the demand for and value of the asset. (Refer to Thrift Activities Regulatory Handbook Section 251, Real Estate Owned and Repossessed Assets, for additional detail.)

Accrued Interest Receivable: Accrued interest is considered a part of the investment in the loan that must be evaluated for collectibility by considering the value of the collateral and any other sources of repayment. Any accrued interest where collection is less than probable should be classified Loss. Otherwise, accrued interest should be accorded the same classification as the underlying loan.

Differences in Accounts and Stale Items: Any unreconciled difference in accounts should be accorded a Loss classification if the difference cannot be located in a reasonable period of time. Types of other assets frequently found in associations are the various temporary holding accounts such as suspense, inter-office, teller, transit, and bookkeeping differences having debit balances. These accounts should be used only for temporary recording until the offsetting entry is identified and posted to the proper account. Nothing should be allowed to remain in those accounts for any significant length of time, normally no more than a few business days. All differences in accounts should be closed out at least quarterly. Unreconciled differences in "Due From Banks" accounts should be reviewed, with long outstanding and undocumented differences considered for a Loss classification. Other stale items, such as returned checks and overdue accounts receivable deemed uncollectible, should also be reviewed for possible adverse classification.

Treatment of Guarantees in the Classification Process: The original source of repayment and the borrower's intent and ability to fulfill the obliga-

tion without reliance on third-party guarantors should be the primary basis for the review and classification of assets. Regulators should, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a " financially responsible guarantor" as described below, may be sufficient to preclude classification or reduce the severity of classification.

A guarantee from a " financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for the remaining indebtedness, in whole or in part, during the remaining loan term; and
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations Relating to the Guarantor's Financial Capacity: The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by the guarantor in order to determine that the guarantor has the financial capacity to fulfill all such contingent claims.

Considerations Relating to a Guarantor's Willingness to Repay: Regulators should normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the guarantor's "track record," including payments made on the asset under review and those made on the guarantor's other financial obligations.

Regulators should give due consideration to those guarantors who have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees of similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. Regulators should give little credence, if any, however, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.

Regulators should also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the loan; or
- Where the guarantees are collateralized by readily marketable assets that are under control of a third party.

Other Considerations: In general, only guarantees that are legally enforceable will be relied upon. All legally enforceable guarantees, however, may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee should also be considered by regulators. For example, some guarantees for real estate projects pertain only to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Regulators should also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of the guarantees should be a positive consideration in the classification process.

Conclusive Presumption of Worthlessness of Debts Held by Savings Associations

The following policy was issued by OTS on November 23, 1992 as Regulatory Bulletin 29:

Background

In 1992, the IRS issued new regulations that relate to the deductibility of loan charge-offs by financial institutions. Under these regulations, institutions may elect to conform their tax accounting for bad debts with their regulatory accounting. Institutions that make this election will automatically be allowed to deduct charge-offs of loss assets for federal income tax purposes in the same year the charge-offs are taken for regulatory purposes.

The new regulations require the institution to maintain loan loss classification standards that are consistent with the standards established for loan charge-offs by its primary federal supervisory agency. If the institution meets these requirements, its loan charge-offs are conclusively presumed worthless for federal income tax purposes. These regulations are effective for taxable years ending on or after December 31, 1991.

Election Requirements

To be eligible, an institution must file a conformity election with its federal tax return. The IRS regulations also require the institution's primary federal supervisory agency to expressly determine that the institution maintains and applies classification standards for loan charge-offs that are consistent with regulatory requirements.

Procedures

The savings association is responsible for requesting an Express Determination Letter (Appendix A). When requested by a savings association that has made or intends to make the election under IRS regulation section 1.166-2(d)(3), the regulator may issue the Express Determination Letter, provided the savings association maintains and applies loan loss classification standards that are consistent with regulatory requirements.

The Express Determination Letter should be issued only at the completion of an examination that covers the association's loan review process, and for which the regulator has concluded that issuance of the Express Determination Letter is appropriate. Regulators should not alter the scope or frequency of examinations merely to permit savings associations to use this new regulation.

The Express Determination Letter should be signed and dated by the examiner in charge and provided to the savings association for its files. The Express Determination Letter is not part of the examination report. The regulator should document in examination work papers his/her conclusions regarding the association's loan loss classification standards.

OTS standards for loan charge-offs and classification standards are set forth in Section 217 (Consumer Lending), Section 218 (Credit Card Lending) and this Section of the Thrift Activities Regulatory Handbook.

The Express Determination Letter should be issued only if:

- The examination indicates that the savings association maintains and applies loan loss classification standards that are consistent with OTS standards regarding the identification of losses and charge-off of loans.
- There are no material deviations from regulatory standards. Minor criticisms of the savings association's loan review process or immaterial individual deviations from regulatory standards should not preclude issuance of the Express Determination Letter.

The Express Determination Letter should not be issued if:

- The savings association's loan review process relating to charge-offs is subject to significant criticism.
- Loan charge-offs for Thrift Financial Report purposes are consistently overstated or understated.
- There is a pattern of loan charge-offs not recognized in the appropriate year.

Revoking the Election

The savings association's election of the new method is revoked automatically if the regulator does not issue an Express Determination Letter at the end of an examination that covers the loan review process. The OTS is not required to rescind any previously issued Express Determination Letters.

A regulator's decision to withhold the Express Determination Letter generally revokes the election for the current year. However, it does not invalidate a savings association's election for any prior year(s). Withholding the Express Determination Letter places the burden of proof on the association to support its tax deductions for loan charge-offs.

Interregion Classifications

Classification of an asset held by associations in more than one region is the primary responsibility of the region in which the lead association is located (lead region). When the lead region has determined the appropriate classification, the classification write-up, as presented in the ROE, and documentation on how the classification was determined, should be distributed to the regions that have associations participating in the asset (participating regions). The documentation should include the calculations used to determine any Loss classification accorded the asset. A Pass classification should also be communicated to the participating regions.

Regional directors may direct associations in their region, or their affiliates or service corporations, to adjust the book value of an asset. Where participants are regulated by another region, the regional director of the lead lender will provide key information to other regional directors, including the adjustment to the book value and a copy of the appraisal report, if applicable. The regional directors of the out-of-region participants should, in turn, communicate the appropriate adjustments to the asset's book value to their associations. Loss allowances and charge-offs should be established in accordance with OTS policy.

The lead lender or any participant has the option to file a request for an informal review pursuant to Regulatory Bulletin 4a as a result of a classification, an appraised value, or a directive to establish allowances.

Regional directors of the lead lender and all participants should ensure that within 30 days of being notified to establish an allowance or charge-off, all associations, service corporations, or affiliates have taken appropriate action or have submitted a written explanation concerning why allowances or charge-offs were not established. In absence of an explanation, or the establishment of an allowance or charge-off, the regional director should initiate necessary supervisory action.

If the lead region has yet to review an interregion asset, the participating region, pursuant to an examination, should review the asset and determine an appropriate classification. If adversely classified, the write-up should be forwarded to the lead region. The write-up may also be sent to other participating regions for informational purposes. This same procedure should be followed in those instances where information has been received subsequent to a lead region's classification, which renders such classification dated and inappropriate.

Work Paper Documentation

Examination findings must be adequately documented in the examination work papers. As with all examination work papers, Classification of Assets work papers should contain clear conclusions and concise analysis, provide sufficient documentation of findings, be properly indexed, and reference all pertinent information sources. In addition, documentation supporting classification of assets must include:

- clear documentation of the examiner's reason(s) for classification decisions;
- a comparison, by classification category (Substandard, Doubtful and Loss), of the examiner's total classified assets with the institution's total classified assets; and
- a clear conclusion concerning the adequacy of the institution's self-classification policies and procedures.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 545.82	Finance Subsidiaries

Subchapter D: Regulations Applicable to All Savings Associations

§ 561.12	Consumer Credit
§ 561.13	Consumer Credit Classified as Loss
§ 561.44	Security
§ 561.47	Slow Consumer Credit
§ 561.48	Slow Loans
§ 563.37	Operation of Service Corporations; Liability of Savings Association for Debt of Service Corporation
§ 563.160	Classification of Certain Assets
§ 563.172	Re-Evaluation of Real Estate Owned
§ 564	Appraisals
§ 571.18	Accounting for Troubled Debt Restructuring
§ 571.21	Separate Corporate Existence of a Service Corporation

Office of Thrift Supervision Bulletins

RB 4a	Supervisory Review Process
RB 29	Conclusive Presumption of Worthlessness of Debts Held by Savings Associations
TB 16	Environmental Risk and Liability

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies
No. 13	Accounting for Leases
No. 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings
No. 65	Accounting for Certain Mortgage Banking Activities
No. 114	Accounting by Creditors for Impairment of a Loan

Other

OTS Notice No. 90-1432, Public Disclosure of Reports of Condition

OTS Transmittal No. 28, Review and Classification of Commercial Real Estate Loans

SEC FRR 28, Accounting for Loan Losses by Registrants Engaged in Lending Activities

AICPA SOP 92-3, Accounting for Foreclosed Assets